

California Debt and Advisory Commission
Mechanics of a Bond Sale

Developing a Debt Management Policy

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Fiscal Health



- Fiscal health is a lot like your personal health—it's not what you live for . . . but it's hard to enjoy your life without it.
- Like personal health, fiscal health is a combination of luck and effort.
- Financial plans and policies are part of the “exercise” of maintaining integrity.

Plans Versus Policies

- Plans are good
 - Any debt issuance should be preceded by longer-term financial and capital improvement plans.
 - What do you plan to do?
 - How do you plan to pay for it?
 - What's the “right” combination of pay-as-you-go versus debt financing?
- But plans change over time as actual results replace assumptions (like, as soon as the laser jet ink is dry).
- Policies are better
 - Are the compass guiding the preparation of your plans.
 - Help making tough decisions easier by telling you what your values are before they are placed under stress by adverse circumstances.

“Plans are nothing; planning is everything.”

Dwight D. Eisenhower

One Place to Start: Fitch Rating Agency's Best Management Practices

➤ Very Significant

- Fund balance policy.
- Debt affordability policy.

➤ Significant

- Pay-as-you-go capital financing.
- Multi-year forecasting.
- Quarterly reporting.
- Quick debt retirement.

➤ Influential

- Contingency plans.
- Non-recurring revenue policy.
- Depreciation of fixed assets (GASB 34 implementation).
- 5 Year CIP integrating operating cost impacts.
- GFOA financial reporting award.
- GFOA budgeting award.

City of San Diego Score Card

- ✓ Fund balance policy
 - Debt affordability policy
- ✓ Pay-as-you-go capital financing
- ✓ Multi-year forecasting (in the works)
- ✓ Periodic interim financial reporting
 - Quick debt retirement
- ✓ Contingency plans
- ✓ Non-recurring revenue policy
- ✓ Depreciation of fixed assets (GASB 34 implementation)
- ✓ 5 Year CIP integrating operating cost impacts
- ✓ GFOA financial reporting award
- ✓ GFOA budgeting award

City of San Diego Score Card

- What is missing from the Fitch list.
 - Debt affordability policy.
 - Quick debt retirement.
- No formal Debt Policy.
 - Debt Policy elements are addressed in City Charter, Administrative Regulations, Council Policies and Management Policies.
- So, I've got an idea, let's do a debt policy?

Elements Appearing in Debt Policy Statements

- | | |
|-----------------------------|--------------------------------------|
| 1 Purposes and uses of debt | 19 Sale process |
| 2 Types of debt | 20 Assessed value |
| 3 Capital expenditures | 21 Analysis requirements |
| 4 Refunding bonds | 22 Reserve capacity |
| 5 Disclosure | 23 Per capita limitations |
| 6 Statutory limitations | 24 Size of issuance |
| 7 Project life | 25 Intergovernmental coordination |
| 8 Rating agency relations | 26 When not to issue debt |
| 9 Operating budget | 27 Operating revenue |
| 10 Revenue and TIF bonds | 28 Lease debt |
| 11 Bond rating goals | 29 Capitalized interest guidelines |
| 12 Misc. limitations | 30 Market value limitations |
| 13 Repayment provisions | 31 Credit enhancement |
| 14 Maturity guidelines | 32 Limited tax GO bonds ¹ |
| 15 General fund revenue | 33 Inter-fund borrowing |
| 16 Expenditure limitations | 34 Variable rate debt |
| 17 Professional services | 35 Debt service funds |
| 18 Short-term debt | 36 Derivatives |

¹In Calif., effectively a lease obligation

Elements of a Debt Policy

- Purposes for which debt may be issued.
- Debt limitations.
- Use of general fund pledges.
- Types of debt permitted, and criteria.
- Structural features.
- Credit objectives.
- Method of sale.

Source: GFOA Recommended Practices

More Elements of a Debt Policy

- Selection of external financial professionals.
- Refunding of debt.
- Disclosure.
- Compliance with federal tax law.
- Integration of capital planning and debt financing activities.
- Investment of bond proceeds.

Source: GFOA Recommended Practices

Purposes for Which Debt May Be Issued

➤ Current S.D. informal policy

- Capital improvements, not operating expenses.
- Essential projects/priority services.
- Quality of life.
- Significant benefit to local economy.
- Urgency of the need.

➤ How can we improve?

- More specific criteria.
- Dedicated funding.
- How do we accommodate flexibility and political reality?
- Determining “capacity” is an art not a science.
 - You can probably borrow as much as you want, but with deteriorating credit and increasing interest rates.

Debt Limitations

➤ Current S.D. informal policy

- City Charter limits bonded indebtedness relative to total assessed valuation (15% of A.V. for water and 10% of A.V. for all other debt).
- By City Council Policy, assessment district bonds may not exceed 10% of a district's assessed valuation.

➤ How can we improve?

- Clarify definition of “bonded indebtedness”.
- Add limits for “non-bonded” indebtedness such as General Fund lease obligations.
- Establish limits for other kinds of enterprise debt, practical limits for water debt.

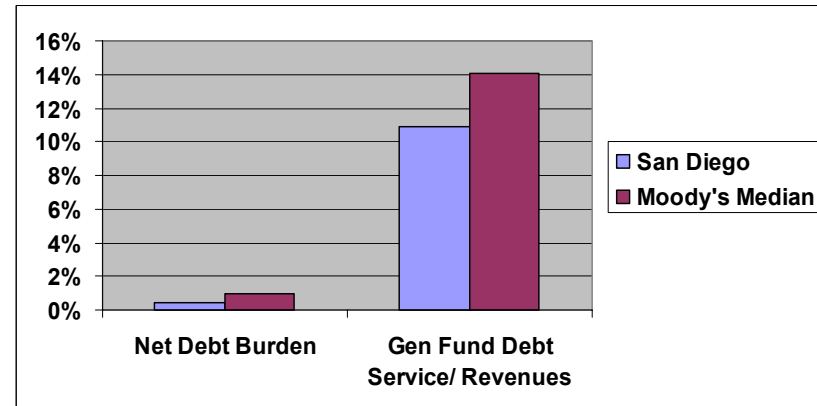
Debt Capacity: General Fund

➤ Common Approaches

- Capacity in policies is often based on standard ratios:
 - Debt as % of assessed valuation.
 - Debt per capita.
- For General Fund debt, debt service as % of revenues or expenditures is common measure.
 - 5% to 10% is within “normal” range.
- Determine how to treat self-supporting debt.
- Include overlapping debt.

➤ Current S.D. informal policy

- Benchmark to rating agency medians.
- City maintains model to adjust both net debt and general purpose revenues to better reflect specific situation.
- Earmark revenue to meet debt service.
- Establish internal debt reserves.



Types of Debt Permitted, and Criteria

➤ Current S.D. informal policy

- General Obligation Bonds – whenever City can obtain the necessary two-thirds approval for the issuance.
- Lease Revenue Bonds and Certificates of Participation – Primary form of financing.
- Revenue Bonds –Charter authorizes revenue bonds to finance improvements to it water and wastewater system.
- 1915 Act Improvement Bonds.

➤ How can we improve?

- GO bonds—Any additional criteria?
- Revenue bonds—When debt, when pay-go?
- General fund obligations
 - Usually the most challenging policies to develop.
 - Address Pension and Judgment obligations?
- Establish limits for other kinds of debt.
 - Assessments and Mello-Roos.

Land-Based Financings

- Often the subject of extensive policies.
 - Permissive or restrictive.
- Topics to consider.
 - Defining the public purpose.
 - Role of city.
 - Applicant Credit Quality.
 - Capitalized Interest.
 - Value-to-Lien Ratio.
- Maximum Burden.
- Benefit/Tax apportionment.
- Special district administration.
- Foreclosure covenants.
- Disclosure to bond holders.
- Disclosure to Prospective Purchasers.

Structural Features—Term

➤ Current S.D. informal policy

- Charter limits term on revenue bonds to 40 years, assessment bonds to 30 years.
- Policy limits term of GO bonds and General Fund backed lease obligations to useful life of the project, not to exceed 30 years.

➤ How can we improve?

- 40 year debt is rare; what are more realistic limits.
- Fitch “Best Practices” cites value of “quick debt retirement”.

Structural Features—Other

➤ Common Features

- Bond features
 - Optional redemption (call).
 - Premium/discount bonds.
- Capitalized interest.
- Debt service structure (level, ascending, descending).
- Use of variable rate debt.

➤ Current S.D. informal policy

- Ten-year optional call.
- Minimize capitalized interest through asset transfers.
- Level debt service.
- No General Fund variable rate exposure.

Method of Sale

- Current S.D. informal policy
 - Preference for competitive sale.
 - Has used negotiated sale for complicated, “storied” credits (e.g., ballpark) and large revenue bond programs.
- How can we improve?
 - Articulate the specific reasons that negotiated sales should be used.

Selection of External Financial Professionals

- Current S.D. informal policy
 - Maintains lists of qualified underwriters, financial advisors, and bond and disclosure counsel.
 - Lists developed through formal RFP processes.

- How can we improve?
 - How best to balance consistency (limited firms) and variety (spreading the business and range of perspectives).

Refunding of Debt

➤ Current S.D. informal policy

- Standard rule of thumb is to achieve present value savings of 3% to 5% of refunded bond issue.
- Look at relative historic rates (where are current rates on business cycle).
- Conservative structure.
 - Take savings over time.
 - No extension of term.

➤ How can we improve?

- Articulate the judgment calls in determining savings threshold.
 - You can only do one “advanced refunding”; make it count.
 - Higher savings appropriate if period to call is long.
 - Minimize negative arbitrage.
 - Lower savings acceptable for shorter deals, other circumstances.

Disclosure

➤ Prior S.D. informal policy ➤ New policies

- Separate disclosure counsel hired for each deal.
 - City maintained the “Appendix A” of the official statement, which included economic and financial information about the City that was common to all financings.
 - Financial statements are included.
- City is in the process of establishing revised policies for bond disclosure.
 - Training in securities law fundamentals for each person that participates in preparation or approval of disclosure documents.
 - Formalized procedures to assure coordination of City’s finance, budget, audit and legal teams.
 - Single disclosure counsel to review not only official statements, but any disclosure made by the City that is reasonably expected to reach investors.
 - Will require opinions by outside counsel covering “Appendix A”.

Some Final Questions for Debt Policies

- Who prepares them?
- Who approves them?
- How detailed should they be?
- How often are they reviewed/updated?

Summary: Policies Are Powerful

- Fundamental foundation for long-term fiscal health.
 - Rationalizes the decision making process.
 - Articulates your values before they are under stress.
- Demonstrates a commitment to long-term planning objectives.
- Helps achieve/maintain favorable ratings by ensuring that use of debt does not unduly limit overall financial flexibility.